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An Intelligence Assessment

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Greece: Economic Problems Defy Papandreou's Solutions [redacted]

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An Intelligence Assessment

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Key Judgments

Information available as of 14 January 1983 was used in this report.

We believe the Greek economy remains as much a liability for the socialist government as it was for its predecessor. Prime Minister Papandreou can with some justification blame his problems on the world recession and the policies he inherited, but he has increased inflationary pressures by hiking government spending and has discouraged much-needed investment by alienating the business community with higher taxes, wage increases, price controls, and threats of nationalization. Weakness in some key categories of the balance of payments have, to a degree, been masked by drawdowns of oil stocks and foreign exchange reserves, borrowing abroad, and an increase in receipts from the EC budget.

Although the Prime Minister may have resigned himself to a more gradual implementation of his social programs, we think he is unlikely to embrace corrective measures fully or quickly enough to restore Greece's economic health. Balance-of-payments problems and an inflation rate already the highest in the European Community will argue for restraint. But he probably will meet strong resistance from labor—his major constituency—to any decline in real wages. We believe that Papandreou will continue economic policies that fall short of the country's needs, and that popular support for the government will erode if Greece lags the rest of Western Europe in the economic recovery.

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Greece: Economic Problems Defy Papandreou's Solutions [redacted]

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A Meager Inheritance

Greece was experiencing severe economic problems before Papandreou took office. Indeed, public dissatisfaction with New Democracy's handling of the economy was a major factor behind his election. Economic growth slowed sharply during 1979 and 1980, and in 1981 GNP fell. Meanwhile, the inflation rate hovered around 25 percent, and the current account deficit ballooned from $1 billion in 1978 to a record $2.4 billion in 1981. While OPEC price hikes and the world economic slump exacerbated Greece's problems, policy mistakes also played a key role. New Democracy made a bad situation worse with massive preelection spending that pushed the 1981 public-sector deficit to an extraordinary 17.4 percent of GNP. The former government failed to resolve such structural difficulties as a topheavy and underdeveloped banking system, an overstaffed bureaucracy, an antiquated tax system incapable of coping with widespread evasion, and a sheltered manufacturing sector made up largely of small inefficient firms. [redacted]

Papandreou's First Year: Expanding Government's Role

Although Papandreou has been more moderate than his campaign rhetoric implied he would be, he nonetheless has significantly increased government intervention in the economy. Taxes and spending are both up sharply, and the minimum wage has been hiked substantially. The government has taken over some firms and kept the exchange rate overvalued. Business has been hit hard by price controls, higher taxes and labor costs, and uncertainty about the future of the private sector. [redacted]

The government's problems in implementing policy have stemmed in part from the inexperience of ministers and the unresponsiveness of the bureaucracy. [redacted], Papandreou sacked his three main economic ministers in a cabinet shuffle last July. He then appointed Gerasimos Arsenis—a technocrat—to the new post of Minister of National Economy, allowing him to retain his position as head of the central bank. [redacted] 25X1

The 1982 budget signaled the government's intention to expand the role of the state in the economy by projecting a 34-percent increase in spending, an increase far in excess of the inflation rate. At the same time, the budget overoptimistically projected a 56-percent increase in revenues and a reduction in the public-sector deficit. Public utility charges were raised soon after Papandreou's election in an effort to reduce the losses of state firms, but official estimates suggest that the combined deficit of state enterprises was up 48 percent in 1982. [redacted] 25X1

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In line with the PASOK (Panhellenic Socialist Movement) view that inequitable income distribution is a major social, economic, and political problem, labor has been a favored client. In addition to legislating a partial indexing of public-sector wages (lower income groups get full compensation for inflation, while those in higher brackets get progressively less), the government has increased the minimum wage an average of 35 percent. Unions have been strengthened by legislation that, for example, permits sympathy strikes and protects workers from strike-related dismissals, while restricting employers' lockout rights. In an effort to reduce joblessness, Athens is subsidizing industries that create new jobs for youth, preventing firms from closing or laying off workers (even if they are losing money), and boosting employment in the already overstaffed government sector. [redacted] 25X1

Agriculture—which still employs about 30 percent of the labor force—also has been treated well. The government sharply boosted pensions for farmers and has proposed higher support prices and low-cost loans. It is pushing agricultural cooperatives as a means of sharing the cost of technological improvements and eliminating the "monopoly of the middleman." [redacted]

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The situation for business is quite different: profits have been badly squeezed between, on the one hand, higher taxes and labor costs and, on the other, price controls on many products. Although Papandreou's threatened nationalization of key sectors has not materialized, government actions and rhetoric keep the possibility in the spotlight. The Larco steel company was nationalized, albeit largely to prevent it from closing and laying off several thousand employees. Athens tried to portray its buyout of the ESSO Pappas oil company—the largest single US investment in Greece—as a first action against the multinationals, although the company initiated the sale. In addition, the government is insisting on renegotiating its contract with the North Aegean Petroleum Corporation (NAPC)—a consortium jointly owned by Canadian, West German, and US firms—touting the move as part of the effort to reclaim control over Greece's natural resources. Athens forced NAPC to shut down its operation temporarily by refusing to purchase oil from the firm's offshore Prinos oilfield except at below-market prices and by withdrawing permission to export oil. The Energy Minister has denied earlier reports that he had raised the prospect of buying out the oil consortium, but he has continued to press for a settlement on pricing and a renegotiation of the 1975 licensing agreement along lines that would give the state greater control. Finally, Athens forced the troubled Prykal munitions company into bankruptcy by withdrawing approval for a large Middle East contract and, according to the company, failing to pay a $7 million bill for materials supplied to the Greek armed forces. Control of the company, has passed to the state-owned National Bank of Greece.

The PASOK government scrapped its predecessor's generous new Investment Incentives Law immediately upon taking office and kept potential investors on hold for more than a year before implementing a slightly more restrictive version. The new law provides government grants for investments that meet certain criteria, such as bringing in advanced technology, providing jobs, or working for the "social good." Firms receiving large grants must give the government equity in new ventures and a voice in their management. The revised law adds new steps to the review process that may prove complicated and time consuming.

Disappointing Results

The Greek economic situation has deteriorated further under Papandreou. With a slump in investment outweighing the stimulative effects of higher government spending and wage hikes for lower income groups, GNP probably registered another decline in 1982. Manufacturing output plunged 15 percent from January to August, seasonally adjusted, and for the first eight months of 1982 averaged 4 percent below the level a year earlier. Moreover, the construction sector has been depressed, and the new property tax is worsening a bad situation. 25X1

Athens estimates unemployment in urban areas at 8 percent of the labor force and rising. The labor force is growing faster than domestic jobs are being created, and job opportunities abroad have dropped off because of the worldwide recession. The net outflow of workers of the 1970s has been succeeded by a net influx. 25X1

While most EC countries have managed to slow price increases during the past two years, Greek inflation dipped only briefly in late 1981 before resuming its rapid pace. Prices rose 21 percent on average in 1982. This occurred despite the recession, the weak oil market, and price controls on key products. Higher wages have added to inflationary pressures. Papandreou's generous wage policies led to a 36-percent increase in average hourly earnings in the first half of 1982 despite rising unemployment. 25X1

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Labor unrest has aggravated the economic situation. Despite Papandreou's favorable treatment of unions, Greece has been plagued by strikes, including sporadic airline walkouts and a six-week bank strike last summer that seriously hampered commerce. The strike was settled by Arsenis's direct intervention, and even then the concessions to the already well-paid bank employees exceeded Athens's guidelines. 25X1

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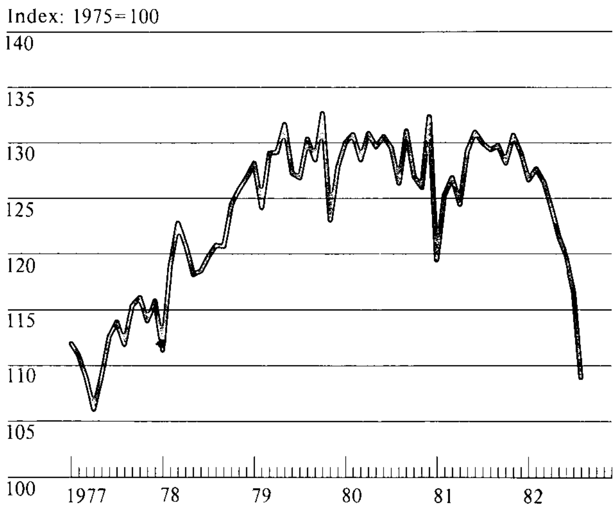
Figure 1
Greece: Manufacturing Production[a]



[a]Seasonally adjusted.

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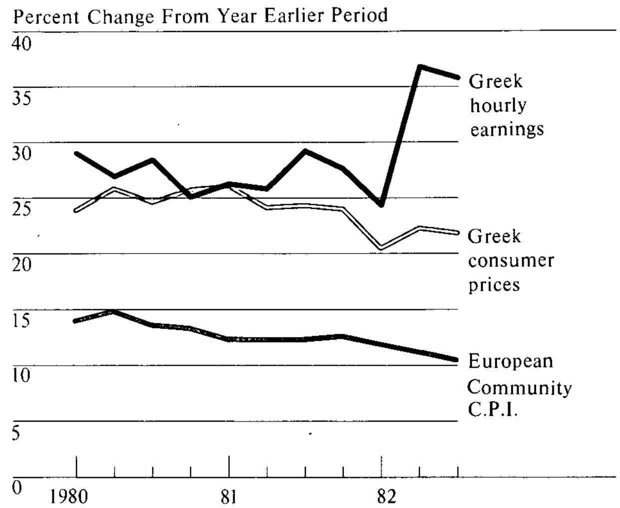
Figure 2
Greece: Prices and Wages



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Danger Signs in the Balance of Payments
The most alarming economic deterioration since Papandreou took office probably has been in the balance of payments. The $300 million narrowing of the current account deficit in the first 10 months of 1982 is misleading: almost all the major categories of foreign exchange earnings have been doing poorly, and only a sharp increase in net inflows from the EC budget and a temporary decline in oil import volume prevented the deficit from running well ahead of the previous year's record level. EC transfers were $250 million higher in January-August 1982 than in the comparable period of 1981 and probably reached $600 million for the entire year—four times the 1981 level. Total imports were down 11 percent in the first 10 months of 1982. The $900 million drop was due mainly to a decision to run oil stocks down to a 90-day supply; nonoil imports declined only slightly.[1]

[1] The discussion of the balance of payments is based largely on official Greek data. We suspect there may be some errors in this information as a result of the six-week bank strike last summer.

The Greek central bank reports that exports were down 12 percent in dollar terms in the first 10 months of 1982, compared with the same period in 1981. Slumping foreign demand almost certainly was a factor, but declining Greek competitiveness probably played an even greater role. Greece's inflation rate has been considerably higher than those of its main trade partners, and creeping devaluations had been insufficient to maintain competitiveness. In inflation-adjusted terms, the drachma had become overvalued by more than 20 percent against the West German mark and 30 percent against the French franc relative to mid-1980. 25X1

While contributions from the EC budget are up, the invisibles earnings that Greece normally relies on to offset its trade deficit have declined. Earnings from shipping were down 9 percent in the January-October period as the Greek fleet was hard hit by the decline

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Table 1
Greece: Balance of Payments

Million US $

	1980	1981	1982 [a]
Current account	**−2,216**	**−2,408**	**−2,200**
Trade balance	−6,809	−6,697	−6,300
Exports	4,094	4,771	4,300
Imports	10,903	11,468	10,600
Oil	2,982	3,685	2,800
Nonoil	7,921	7,783	7,800
Invisibles balance	4,593	4,289	4,100
Receipts	6,159	6,495	6,350
Net EC inflows	0	148	600
Payments	1,566	2,206	2,250
Interest and dividends	466	823	750
Capital account	**2,320**	**1,888**	**2,040**
Private inflows	1,622	1,310	800
Official borrowing	1,197	1,231	2,040
Principal repayment	499	653	800
Overall balance	104	−520	−160
Change in reserves	−1	−328	−160
Change in other assets, IMF	70	140	
Errors and omissions	35	−332	

[a] Estimated.

in world trade. Greece is losing its traditional cost advantage in shipping as seamen's pay moves up toward the European norm. Emigrant remittances continue to slide—down 6 percent in the first 10 months of 1982 after dropping 11 percent between 1979 and 1981. Tourism earnings—the star performer in the balance of payments in the late 1970s—suffered an 18-percent drop in January-October 1982.

Serious problems have surfaced in the capital account as well. The net inflow of private capital, which traditionally covers about half of the current account gap, was off by 40 percent in the first eight months of last year compared to the same period in 1981. Depressed business confidence and statements by some government officials disparaging foreign investment have discouraged capital inflows and, despite exchange controls, almost certainly caused some capital flight.[2] Finally, much hoped-for investments from Arab countries have not materialized.

These developments have required a greater reliance on official borrowing and a drawdown of foreign exchange reserves to less than one month's worth of imports. A major loan was arranged from a group of banks in March 1982 on only slightly stiffer terms than obtained in previous years, but bankers have since become even more cautious in their medium-term lending. Indeed, Greece's chief foreign loan negotiator stated privately to a US official that the country is entering a "foreign exchange crisis." He indicated that Athens is hoping to cover its needs over the next few months by relying on short-term, bank-to-bank credits, but soon it probably will have to seek a sizable new official loan of longer maturity. Total foreign debt is now over $10 billion. Although Greece's debt service ratio—about 15 percent taking into account receipts from both exports and invisibles—is not particularly alarming when compared to ratios of other countries, it has doubled over the last four years and is still rising rapidly. 25X1

The Current Policy Situation

Although Papandreou can claim with some justification that Greece's current economic bind is due in large measure to the policies of his predecessor and to external factors, we believe that his actions have aggravated the country's problems. His programs have reduced profits and undercut business confidence, major factors, we believe, in the decline in both foreign and domestic private investment. And in the face of the continuing huge budget deficit—financed largely by monetary expansion—his price controls are bound to reduce profits further and impede the efficient allocation of resources. Even on the unemployment front, where direct steps have been taken to create or preserve jobs, it is likely that, on balance, government actions have worsened the outlook. Measures such as higher minimum wages and benefits, recent prolabor legislation, and restrictions on layoffs impede new hiring and tend to discourage job-creating investment.

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[2] While capital flight is difficult to quantify, the drop in net capital transfers into Greece and Athens's actions to tighten exchange controls indicate it is a problem. 25X1

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Table 2
Greece: Economic Indicators

Percent

	1978	1979	1980	1981	1982 [a]
Real GDP growth	6.7	3.7	1.6	−0.7	−0.5
Fixed investment growth	6.0	7.9	−8.7	−12.1	−10.0
Inflation rate	12.5	19.0	24.9	24.5	21.0
Foreign debt service [b]	7.6	8.4	9.4	13.1	15.0
Ratio of public-sector borrowing to GDP	8.0	9.0	12.0	17.0	15.0
Current account balance (*billion US $*)	−1.0	−1.9	−2.2	−2.4	−2.2

[a] Estimated.
[b] Debt service as a percent of earnings from exports and invisibles.

[redacted]

Papandreou has labeled his 1982 policies a transition to the five-year plan to be launched in 1983. The plan was to have been unveiled late last year but now is expected in March of this year. The plan should provide further indications of whether Papandreou is still clinging to the socialist ideals outlined in his campaign or has accepted the need for more pragmatic, restrained policies. We expect the plan to contain some obligatory socialist rhetoric and optimistic goals for economic progress. It will probably include proposals for reform of the inefficient health and welfare system, sharply increased public investment, measures to encourage the development of advanced technology industries, development of export-oriented and import-substitution industry, and the "socialization" of some sectors of the economy. [redacted]

Papandreou's latest vision of socialization appears to include the creation of councils made up of representatives from labor and government to exercise "social control" over key industries. This system would, in our view, involve more regulation and red tape for the already overregulated private sector. Recent legislation affecting the pharmaceutical industry could result in a virtual government monopoly of the manufacture and distribution of pharmaceuticals. Many of the multinational firms involved—20 are US owned—have threatened to pull out of Greece if government control becomes too great. Other key sectors that are candidates for socialization include insurance and energy. Furthermore, financially troubled firms in any sector are subject to takeover, either directly or by state-controlled banks, because Athens fears the political backlash of plant closings and the layoff of more workers. [redacted]

Papandreou appears to be increasingly concerned about the economic situation, and we believe he realizes that an all-out effort to implement PASOK's socialist program over a short period would be disruptive for the fragile Greek economy. Apparently recognizing that postponing austerity measures would merely force a politically more expensive retrenchment later, Papandreou has begun talking less about "socializing" Greece and more about the need for patience and sacrifice. Minister of National Economy Arsenis now says that PASOK's plan for Greece may take much longer to implement than the four or five years originally envisioned. [redacted]

This gradual shift toward pragmatism is evident in the 9 January devaluation of the drachma and in the recently announced incomes policy for 1983. The 15-percent devaluation, however was belated and lacked a commitment to maintain a realistic exchange rate through more rapid depreciation. Moreover, the devaluation was accompanied by protectionist measures to restrict imports—particularly from EC partners—to the 1980 level. The new incomes policy provides for significant delays in cost-of-living adjustments that should hold wage increases in 1983 well below the inflation rate. Although Papandreou has promised publicly that any real wage shortfall will be made up in 1984 and that there will be bonuses to match real GNP growth, the policy represents a major change in course. If carried out, it would actually erase—at least temporarily—most of the real wage gains made by labor in 1982. [redacted] 25X1

The recently announced government budget for 1983, on the other hand, offers little evidence of any other policy shift. It projects increases of 29 percent for expenditures, 32 percent for revenues, and 20 percent for the total public-sector deficit. Social services spending is to rise 36 percent and public investment is

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projected to jump 48 percent, while spending on agriculture and defense will grow more slowly than in 1982. Increased revenue is expected from sharp hikes in automobile and fuel taxes, greater net transfers from the European Community, and anticipated higher charges for public utilities. In our view Athens has overestimated the gains from increased economic activity and a crackdown on tax evasion. Even with the optimistic revenue projections, the budget deficit is projected to remain over 15 percent of GDP. [redacted]

It is increasingly unlikely that Papandreou will pursue his earlier threats to withdraw from the European Community or submit the issue to a referendum. He is acutely aware of the growing importance of agricultural support funds and regional development assistance in reducing deficits in both the current account and the government budget. Athens has complained about a flood of imports from EC partners following Greece's lowering of trade barriers, but the recent deterioration in the balance of trade with the Community is due more to falling Greek exports. One unpleasant surprise: the Greek balance on food trade with the Nine has gone from surplus to deficit since Greece joined the Community. [redacted]

Papandreou apparently is satisfied by the Community's willingness to consider Athens's request for preferential treatment and a "special relationship." According to the US Embassy in Athens, he believes he has considerable leverage because his EC partners fear that economic problems could generate a threat to Greek democracy. Papandreou believes the Community will not press Greece on its obligations; Athens already has delayed implementation of most EC directives and its takeovers, proposals for reducing competition in the drug industry, and talk of delay in introducing a value-added tax have raised eyebrows in Brussels. Highlighting Greece's less developed status and its current inability to meet the Community obligations imposed on it, Papandreou probably will settle for arrangements easing Greece's transition to full participation rather than press for renegotiation of the terms of its accession. [redacted]

Outlook

We believe the state of the economy will continue to be the single most important standard against which the Greeks measure Papandreou's performance. This will put the Prime Minister in an increasingly difficult position. On the one hand, inflation and balance-of-payments problems will push him toward more restrictive policies. On the other, he will face mounting labor unrest and pressure from within his own party to implement his socialist program. [redacted]

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Given these conflicting pressures, we expect that Papandreou will chart a middle course that will neither satisfy any of his constituencies nor restore economic health. Recent announcements, including the recent devaluation and the restrictive 1983 incomes policy, signal some movement away from Papandreou's sharply expansionary policies but no serious turn toward needed austerity measures. To deal effectively with Greece's economic problems we believe Athens would need to adopt more restrictive fiscal and monetary policies, reduce the budget deficit, ease government controls (particularly on prices), and adopt a more favorable attitude toward private investment. [redacted]

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We believe Athens's claims for the new budget and the incomes policy as anti-inflationary are exaggerated. The deficit will keep pressure on money supply growth and crowd out productive private investment. As for the more restrictive incomes policy full implementation this year is questionable, given strenuous objections and strike threats from labor, and Papandreou has promised to reverse the policy in 1984. [redacted]

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We think it unlikely that investment will pick up significantly in 1983, even with the new investment law in place. Continued low profits and excess capacity alone argue against recovery. Moreover, most businessmen probably will remain cautious until the government takes a more positive position on the role

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of the private sector. Arsenis has said that there is "room" for the private sector in a mixed economy, but he goes on to argue that private firms must be subject to "social control" designed to assure that "the traditional private sector will promote the more general national interest."

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The most critical problem over the next year or two probably will be the balance of payments. Athens concealed the deterioration in 1982 with stopgap measures. However, neither oil stocks nor foreign exchange reserves can be drawn down much further, and foreign loans probably will be more difficult to obtain as international bankers become increasingly troubled by trends in the Greek balance of payments (and perhaps in Athens's policies) and by world debt problems. With the volume of oil imports returning to normal, the current account deficit could set a record in 1983. The import restrictions may mask the problem temporarily, but if Athens does not continue its depreciation of the drachma to offset the high inflation rate, the deficit could continue to widen in 1984 as well, perhaps even forcing Papandreou to turn to EC or IMF emergency loan facilities.

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In short, we believe that during the next few years Greece will continue to be plagued by a very sluggish economy, continued high inflation, and a serious payments deficit. Papandreou will, with some justification, blame the world recession for Greece's difficulties; but public dissatisfaction will grow if other West European countries begin to make significantly greater progress in their own battles against stagflation.

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